

LEGISLATIVE AUDIT COMMISSION



Review of
State Universities Retirement System
Year Ended June 30, 1998

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REVIEW: 4069
STATE UNIVERSITIES RETIREMENT SYSTEM
YEAR ENDED JUNE 30, 1998

FINDINGS/RECOMMENDATIONS - 5

ACCEPTED - 4
IMPLEMENTED - 1

REPEATED RECOMMENDATIONS - 4

PRIOR AUDIT FINDINGS/RECOMMENDATIONS - 7

This review summarizes the State compliance audit of the State Universities Retirement System for the year ended June 30, 1998, filed with the Legislative Audit Commission January 27, 1999. The auditors also performed a financial audit and found the financial statements to be fairly presented.

A new law effective January 1, 1998 required SURS to introduce a portable benefit option to the existing defined benefit plan, and to offer a new defined contribution plan. As of June 30, 1998, the Defined Benefit Plan had two options available--Traditional Benefit Option and the Portable Benefit Option. The new defined contribution plan is known as the Self-Managed Plan.

Defined Benefit Plan--Traditional and Portable Benefit Option

SURS is the administrator of a cost-sharing, multiple-employer public employee retirement system established to provide retirement annuities and other benefits for staff members and employees of the State universities and certain other State educational agencies and for survivors, dependents, and other beneficiaries of such employees. As of June 30, 1998 SURS membership consisted of 77,156 active members; 38,054 inactive members; and 28,032 benefit recipients, for a total of 143,242. Participating employers included 12 universities, 39 community colleges, 17 allied agencies and the State of Illinois.

Traditional benefit option members contribute 8% of their gross earnings, 6-1/2% of those designated for retirement annuities; 1/2% for post-retirement increases; and 1% for survivor benefits. Police officers and fire fighters contribute 9-1/2% of earnings; the additional 1-1/2% is a normal retirement contribution. Members of the portable benefit option contribute 8% of their gross earnings; 6-1/2% for retirement annuities, 1/2% for post-retirement increases, and 1% for enhanced refund benefits. Police officers and fire

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fighters contribute 9-1/2% of earnings; the additional 1-1/2% is a normal retirement contribution.

Members are eligible for normal retirement at any age after 35 years of covered service; after eight years of covered service at age 55; or after five years of covered service at age 62. The annuity is the larger of (a) a percentage of the highest four consecutive years earnings, with the percentage based upon total service credit, or (b) an actuarially determined benefit based upon the total employee and employer contributions and the individual's age at time of retirement. Retirement benefits are payable for life and are subject to a 3% compounded increase each January 1. Disability benefits are payable with at least two years of service credit to participants who are unable to reasonably perform the duties of their assigned position.

Upon termination of service, a lump sum refund is available to all members. Under the traditional benefit option, this refund consists of all member contributions and interest at 4.5%. Under the portable benefit option, this refund consists of all member contributions and total interest credited, plus for those members with greater than or equal to five years of service credit, an equal amount of employer contributions.

Death benefits are payable to named beneficiaries. Under the traditional benefit option, monthly survivor benefits may be paid to eligible survivors if the participant established a minimum of 1.5 years of service credit. If no qualified survivor exists at the date of retirement, the member is paid a refund of all survivor contributions plus interest. Under the portable benefit option, survivor benefits are available through a reduction of the retirement annuity calculated as described above. No refund of survivor contributions is available if there is no qualified survivor at the time of retirement.

Self-Managed Plan

SURS is the plan sponsor and administrator of a defined contribution plan referred to as the Self-Managed Plan (SMP). As of June 30, 1998, SMP had 17 participating employers: six universities, 10 community colleges and one allied agency. SMP had 845 members.

A member's decision to participate in SMP is irrevocable. Existing SURS members are allowed one year from the employer offering date to make their election. New employees are allowed 60 days.

The vesting requirements of SMP members are the same as for those participating in the Defined Benefit Plan. The distribution options available upon reaching retirement are the following: a lump sum distribution consisting of all employee and employer contributions and related investment earnings; a single life annuity; a 50% or 100% joint and survivor annuity; or a single life annuity with a guaranteed period of 10, 15, or 20 years as elected by the participant.

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Disability benefits are the same as the Defined Benefit Plan.

Upon termination of service with less than five years of service credit, a lump sum distribution is available which consists of employee contributions and related investment earnings. The employer contributions and related investment earnings are forfeited. Upon termination of service with greater than five years credit, but where the participant is not yet eligible for retirement, a lump sum distribution is available which consists of employee and employer contributions and related investment earnings.

Management of SURS is vested in a nine-member Board of Trustees appointed by the Governor. Two trustees are participants of the System, two are benefit recipients, and the five remaining trustees may, but need not, be participants or annuitants of the System. The administration of the detailed affairs of the System is vested in the Executive Director, under the direction of the Board. James Hacking, the current Executive Director of the System, was appointed as Executive Director of the System on December 19, 1995.

The average number of SURS employees was as follows:

FY98 - 89; FY97 - 71.

Financial Information

Appendix A provides a summary of the State Universities Retirement Systems' statement of plan net assets. As of June 30, 1998, \$9.794 billion was held in reserve accounts that reflect the assignment of net assets to participant and benefit accounts. This compares to net assets held in trust of \$8.376 billion one year earlier, and represents an increase of \$1.4 billion, or 14.5%. Investments, including those from the Self-Managed Plan, were carried at market value of \$9,649,007,658 at June 30, 1998.

Appendix B provides a statement of revenues and expenditures of the SURS. During FY98 the System experienced \$1.4 billion in excess revenues over expenses. Contributions by members were \$221.8 million, or 11.5% of total income; contributions by employers were \$227.8 million, or 11.8% of the total; and investment income and net gain on sale of investments was \$1,474.6 million, or 76.6% of total revenues. Investment income (including net gain on sale of investments) decreased from \$1,490.0 million in FY97 to \$1,474.6 million. Benefits increased from approximately \$419 million in FY97 to \$466 million as a result of a 6.6% increase in the number of retirees, survivors and members with disabilities from 26,158 in FY97 to 28,083 in FY98.

The funding ratio is a commonly used indicator of the financial stability of a pension fund. It illustrates the unfunded liability in greater detail by placing the liabilities in the context of the System's assets. Expressed as a percentage of a fund's liabilities, the funding ratio is calculated by simply dividing net assets by the accrued liabilities. The result is the percentage of the accrued liabilities that are covered by assets. At 100%, a fully funded

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system has sufficient assets to pay all benefits earned to date by all its members. The

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State Universities' Retirement System funding ratio for FY98 and FY97 was as follows:

<i>FY98</i>	<i>FY97</i>
85.8%	79.4%

Administrative Expenses

Appendix C provides a summary of administrative expenses. Salary expenditures increased by 30% from FY97 to FY98 due to an average wage increase of 6.3% and the addition of 25 new positions. These new positions consisted of 13 information systems positions and 12 new positions in member service support, data entry, and clerical areas. The reasons for the additional staff were due to the legislative changes which took effect on January 1, 1998, and the April 1, 1998 offering of the new retirement option and the Self-Managed Plan.

Increases of 26.2% in group health insurance costs and 25.9% in retirement contributions are both attributable to the increase in number of employees. The 82% increase in postage was due to three factors: publishing and mailing one additional edition of the member-wide newsletter; mailing the CMS insurance handbook to benefit recipients; and mailing the educational materials about the new retirement options to each member.

Legal services increased 77% due to the significant increase in hours of services used related to the development of the Self-Managed Plan and the higher hourly rate billed by the new legal services vendor. Other professional fees increased 63% because of costs to administer the Self-Managed Plan. Printing and copying services increased 148% due to the additional issue of the member-wide newsletter and the educational materials prepared on the new retirement options.

Investments and Expenses

Appendix D provides a summary of the System's investments for fiscal years 1994-98 and the annualized rate of return for three, five, and 10 years. The 1998 investment return for the System was 17.8%, down from the five-year high in FY97 of 21.4%. During FY98, SURS' investment policy consisted of a portfolio constructed according to the following guidelines: 50.5% in domestic equity securities; 17.5% in international equity securities; 30% in fixed income securities; and 2% in real estate. According to the System's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1998, SURS' investment objective is to exceed the composite market benchmark or policy portfolio rate of return. During FY98, SURS' total fund return fell short of the System's policy goal by 0.4%. For the 10 years ended June 30, 1998, SURS' total fund results remained ahead of

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both its benchmarks, the policy portfolio, and the median return for public pension funds for the three, five, and 10-year periods.

Appendix E and Appendix F provide a summary of investment expenses for FY98 and FY97. Investment expenses include fees paid to the System's Master Trustee, various investment managers and their investment consultants, and investment brokerage firms. Fees are negotiated primarily on market values and the manager's portfolio performance. A graduated scale is used for most managers based on various increments per million dollars of market value. Investment expenses also include administrative expenses relating to the operations of the investment division of SURS. Total investment expenses were \$13,265,935 during FY98, compared to \$12,520,857 during FY97. In addition, investment commissions, which are fees paid to investment brokerage firms for the purchase and sale of investments, totaled \$2,174,686 in FY98 and \$1,404,881 during FY97.

Self-Managed Plan

During FY98, SURS began offering to its active and future members a defined contribution plan as an alternative to the traditional defined benefit plan. Participants in the Self-Managed Plan (SMP) have the ability to invest their account balances in 40 mutual and variable annuity funds. The Self-Managed Plan is financed by employee and employer contributions and investment earnings, but the funds are held by the three Service Providers approved by the Board of Trustees: Aetna, ICMA Retirement Corporation, and Teachers Insurance and Annuity Association College Retirement Equities Fund (TIAA/CREF), offering 14, 18, and 8 funds, respectively. As of June 30, 1998, the fair market value of all Self-Managed Plan investments was \$1,581,209. Asset allocations are detailed in the table below.

Asset Allocation	Amount	Percentage
Aetna Funds	\$ 226,521	14.3%
ICMA Funds*	922,840	58.4
TIAA/CREF Funds	431,847	27.3
<hr/> *ICMA is the default fund for members who have selected the self-managed plan, but have not yet selected individual mutual/variable annuity funds.		

Accountants' Findings and Recommendations

Condensed below are the five findings and recommendations presented in the audit report. Four of the recommendations were repeated. The following recommendations are classified on the basis of information provided by Steve Hayward, Internal Auditor, State Universities Retirement System, in a letter dated April 13, 1999.

Accepted

- 1. Strengthen controls over benefits and refunds or revise controls over claims and disbursements to insure all documentation is complete and all claim calculations properly performed and documented. (Repeated-1997)**

Findings: Documentation of SURS' benefits/refunds or claims/disbursements calculations and participant eligibility were insufficient to substantiate the amount and the eligibility, which could result in inaccurate payments.

- Adequate audit trails and supporting documentation do not exist for the on-line claims systems or in members' image files.
- Four of 20 files tested did not have the proper documentation signed by physicians certifying an employee disability.
- One of 40 files tested did not contain the Employee Statement from the original year of the survivor annuity. Also, all 1991 survivor statements of accounts are not on the Image system.

Response: The System agrees. The System expects to be compliant with the on-line claims documentation by September 1999. SURS has complied with the requirements for disability certification. As a result of PA90-0766, disability claims after August 1998 will need certification by only one doctor instead of two. 1991 survivor statement of accounts are scanned into member files.

- 3. Design and implement computer controls to restrict changes or modifications to source code once it is tested and approved for migration to the production environment; establish formal program change control procedures to an application in the production environment; and create a control environment to insure that program source code is maintained in both the production and test environments. (Repeated-1996)**

Findings: SURS does not have adequate procedures and processes in place to insure the integrity of data and programs during the development period.

- Application programmers have the ability to make modifications to an application once the user has tested and authorized the application change for migration to the production environment on the ES9000 platform.
- Formalized program change control procedures that document the process of making controlled changes to an application in the production environment are not in place.
- A program change control process insuring that program source code is maintained in both the production and test environments does not exist.

Response: The System agrees and is working on the implementation of each recommendation. All recommendations are expected to be implemented by June 1999.

- 4. Implement formal security administration processes to: grant access to the operations systems based on formal authorization from system administrators; monitor access to applications to detect unauthorized access in a timely manner; and revoke access to application systems in a timely manner to prevent unauthorized access for the users who no longer have a business need.**

Findings: SURS does not have adequate controls to insure that all security access granted to users of the AS/400 is properly authorized. Two logons within the AS/400 production environment were active and neither logon had documentation to justify its presence.

Response: The System agrees and is working on the implementation of each recommendation. All recommendations are expected to be implemented by May 1999.

- 5. Obtain updated IRS determination letters and implement procedures to obtain updated IRS determination letters on a timely basis for any future major change in SURS' pension programs.**

Findings: SURS obtained its most recent IRS determination letter in 1956. Updated IRS letters are needed for the two major programs initiated within the past two years.

Response: The System agrees and has filed a determination letter request for the Self-Managed Plan and is preparing a determination request for the Defined Benefit Plan which includes both the traditional and portable options. The System will obtain determination letters periodically in the future.

Implemented

- 2. Follow established policies and procedures for the approval of goods and services. It may be beneficial to perform a cost/benefit analysis of changing to an automated computer-based preventive control to insure all purchases over \$500 and all contracts are properly approved with proper documentation prior to the delivery of goods or commencement of services by vendors. (Repeated-1995)**

Findings: The System's internal controls over approval of goods and services were not operating effectively and could result in unauthorized payments.

- One invoice totaling \$6,100 was paid without an approved purchase order. The same invoice also had improper documentation for the purchase of computer materials.
- One contract totaling \$9,431, out of 25 contracts reviewed, was signed on April 2, 1998, but the services were performed on January 30, 1998.

Response: The recommendation was implemented in November 1998.

Headquarters Designations

The State Finance Act requires all State agencies to make semiannual headquarters reports to the Legislative Audit Commission. Each State Agency is required to file reports of all its officers and employees for whom official headquarters have been designated at any location other than that at which official duties require them to spend the largest part of their working time.

The System indicated it had no employees assigned to locations other than official headquarters during FY98.

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APPENDIX A

Statement of Plan Net Assets			
ASSETS	1998 Self-Managed Plan	Total 1998	Total 1997
Cash & short term investments	\$ -	\$ 460,282,838	\$ 666,316,945
Receivables			
Participants	30,834	16,170,335	9,292,939
Federal, trust funds, & other	65,938	1,337,723	344,868
Employer - long- term	-	1,794,167	1,682,139
Pending investment sales	-	126,243,506	130,956,926
Interest & dividends	-	27,736,948	20,700,409
Total receivables	96,772	173,282,679	162,977,281
Prepaid expenses	-	29,396	25,000
Investments, at fair value			
Equity investments	-	6,852,903,345	5,696,018,450
Fixed income investments	-	2,660,031,036	2,028,156,816
Real estate investments	-	134,492,069	178,817,319
Mutual fund & variable annuities	1,581,208	1,581,208	-
Total investments	1,581,208	9,649,007,658	7,902,992,585
Securities	-	506,584,024	318,109,886
Properties, at cost, net of accum. depreciation of \$7,780,386 and \$7,325,170, respectively	-	14,341,417	13,369,914
TOTAL ASSETS	\$ 1,677,980	\$ 10,803,528,012	\$ 9,063,791,611
LIABILITIES			
Benefits payable	-	4,202,000	3,210,000
Refunds payable	-	2,525,000	1,875,000
Securities lending collateral	-	506,584,024	318,109,886
Payable to brokers for unsettled trades	-	473,418,203	342,247,386
Bonds & interest payable	-	17,354,091	16,144,456
Administrative expenses payable	-	5,766,812	5,857,580
TOTAL LIABILITIES	\$ -	\$ 1,009,850,130	\$ 687,444,308
NET ASSETS HELD IN TRUST	\$ 1,677,980	\$ 9,793,677,882	\$ 8,376,347,303

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APPENDIX B

Revenues and Expenses

<u>REVENUES</u>	<u>1998</u>	<u>1997</u>
Participants	\$ 221,769,326	\$ 202,181,711
Federal, trust funds, other	25,962,120	22,331,577
State of Illinois	201,624,000	159,547,000
Reciprocity	212,506	162,292
Total Contribution Income	<u>449,567,952</u>	<u>384,222,580</u>
Investment Income:		
Interest	113,753,599	104,446,588
Dividends	54,520,698	38,197,426
Net appreciation in fair value of investments	842,209,031	882,951,260
Other	<u>1,055,193</u>	<u>731,260</u>
Total Investment Income	1,011,538,521	1,026,326,534
Net Investment Expense	998,272,586	1,013,805,707
Investment Expense	(13,265,935)	(12,520,827)
Net Gain on Sale of Investments	<u>476,317,042</u>	<u>476,223,845</u>
TOTAL REVENUES	<u>1,924,157,580</u>	<u>1,874,252,132</u>
<u>EXPENSES</u>		
Benefits	466,508,747	419,204,096
Refunds	29,680,325	29,846,006
Administrative Expense	9,428,294	7,545,241
Bond Interest Expense	<u>1,209,635</u>	<u>1,125,297</u>
TOTAL EXPENSES	<u>506,827,001</u>	<u>457,720,640</u>
Excess Revenues Over Expenses	<u>\$ 1,417,330,579</u>	<u>\$ 1,416,531,492</u>

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APPENDIX C

Administrative Expenses

	FY98	FY97	Increase (Decrease)	
			Dollar	Percent
Salaries	\$ 3,137,123	\$ 2,412,406	\$ 724,717	30.0 %
Health insurance/medicare	387,135	306,806	80,329	26.2
Retirement	253,297	201,219	52,078	25.9
Postage	478,356	262,440	215,916	82.3
Equipment repair/rental	231,418	196,739	34,679	17.6
Actuarial services	100,500	87,675	12,825	14.6
Legal services	229,656	129,554	100,102	77.3
Other professional services	2,383,482	1,702,086	681,396	40.0
EDP equipment, rental, supplies	33,192	31,820	1,372	4.3
Telephone	116,792	117,418	(626)	(0.5)
Travel	108,307	70,635	37,672	53.3
Printing	405,970	163,538	242,432	148.2
Dues/subscriptions	20,352	12,373	7,979	64.5
Office supplies	49,532	50,945	(1,413)	(2.8)
Conference expenses	15,395	16,525	(1,130)	(6.8)
Building operations	176,174	183,074	(6,900)	(3.8)
Depreciation	1,290,287	1,576,368	(286,081)	(18.1)
Employee tuition/fees	11,326	23,620	(12,294)	(52.0)
TOTAL	\$ 9,428,294	\$ 7,545,241	\$ 1,883,053	25.0 %

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APPENDIX D

Investment Summary

<u>Investment Return</u>	<u>Fiscal Year</u>					<u>Annualized</u>		
	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>3 YRS</u>	<u>5 YRS</u>	<u>10 YRS</u>
<u>Total Fund</u>								
SURS	0.8 %	16.5 %	18.3 %	21.4 %	17.8 %	19.2 %	14.8 %	12.7 %
Policy Portfolio	1.2	15.3	17.0	20.2	18.2	18.5	14.2	11.6
Public Retirement Funds Index	1.4	15.7	14.0	18.2	17.7	16.6	13.2	12.2
CPI	2.5	3.0	2.7	2.3	1.7	2.2	2.5	3.3
<u>U.S. Common Stock Returns</u>								
SURS	1.1	25.6	26.9	30.1	26.9	27.8	21.5	17.5
Wilshire 5000	1.2	24.7	26.2	29.3	28.9	28.1	21.6	17.6
<u>Foreign Stock Returns</u>								
SURS	10.9	(1.9)	23.0	17.3	3.3	14.2	10.1	5.1
Performance Benchmark	9.9	(2.9)	21.8	17.3	2.3	13.0	9.0	4.7
<u>Bond Returns</u>								
SURS	(1.2)	12.6	6.6	9.4	10.6	9.0	7.5	9.7
Lehman Brothers Bond Index	(1.3)	12.6	5.0	8.2	10.5	7.9	6.9	9.1
<u>Real Estate Returns</u>								
SURS	(5.1)	8.6	6.4	11.2	16.6	11.4	7.4	2.8
Ennis, Knupp & Assoc.	(0.4)	3.7	6.1	11.5	17.0	11.5	7.5	1.7

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APPENDIX E

	<u>Investment Expenses</u>	
	<u>FY98</u>	<u>FY97</u>
Master Trustee & Custodian:		
The Northern Trust Company	\$ 125,000	\$ 168,780
Investment Management Firms:		
Allegis Investment Advisors	-	252,932
American Express Asset Management Intern.	1,234,770	1,132,226
Barclays Global Investors	1,848,457	1,513,250
BlackRock Financial Management	534,731	356,064
Brinson Partners, Inc.	1,468,765	1,356,979
Chicago Title & Trust Company	115,083	59,848
Fayez Sarofim & Company	1,238,506	970,488
Holland Capital Management	-	28,747
Lend Lease	442,603	619,816
Martin Currie, Inc.	686,975	777,017
Northern Trust Global Advisors	452,458	123,478
Pacific Investment Management	1,865,192	1,991,371
Progress Investment Management	595,497	264,560
Rosenberg International Equity	-	59,321
Rosenberg Real Estate Equity	951,374	1,491,683
Scudder Kemper	28,608	58,150
Smith Barney Capital Management	503,215	409,184
Standish, Ayer & Wood, Inc.	554,609	265,842
Total	<u>12,520,843</u>	<u>11,730,956</u>
Investment Consultant, Measurement & Counsel:		
Ennis, Knupp & Associates, Inc.	246,495	240,125
Thomas, Mamer & Haughey	410	1,557
Total	<u>246,905</u>	<u>241,682</u>
Administrative Expenses:		
Personnel	312,420	329,425
Resources, board & travel	39,692	28,939
Performance measurement & database	21,075	21,075
Total	<u>373,187</u>	<u>379,439</u>
TOTAL INVESTMENT EXPENSES	<u>\$ 13,265,935</u>	<u>\$ 12,520,857</u>

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APPENDIX F

Schedule of Investment Commission

<u>Investment Brokerage Firms</u>	<u>1998</u>	<u>1997</u>
BT Alsex Brown	\$ 48,244	\$ -
Deutsche Morgan Grenfell	52,444	17,749
Goldman Sachs & Co.	182,083	11,608
HSBC Investment Bank PLC	63,270	63,587
Kleinwort Benson	168,844	49,782
Merril Lynch Ltd.	252,969	318,723
Morgan Grenfell	76,528	62,327
Morgan Stanley	125,360	42,963
Persing Securities, Ltd.	84,815	-
SBC Warburg & Co. Ltd.	194,761	88,112
All Other	925,368	750,030
Total Investment Commission	<u>\$2,174,686</u>	<u>\$1,404,881</u>